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Alex R. McClean

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THE EXTRATERRITORIAL IMPLICATIONS OF THE SEC'S NEW RULE CHANGE TO REGULATE HEDGE FUNDS

Alex R. McClean[†]

I. INTRODUCTION

On October 26, 2004, the Securities and Exchange Commission's ("SEC") Board of Commissioners voted 3-2 to enact a proposed rule to regulate hedge funds.¹ The SEC proposed the rule on July 28, 2004, after two years of research and evaluation of the industry.² The SEC claims that the rule it chose was "the mildest one possible."³ However, this "mild" rule has been a cause of controversy both within the United States and abroad. Federal Reserve Chairman Alan Greenspan, Treasury Secretary John W. Snow, President George W. Bush, and the Republicans in both the House and the Senate opposed the new rule.⁴ Two of the three Republican Commissioners at the SEC opposed the rule as well.⁵ Regulators in the European Union sent comment letters to the Commission expressing concerns about the extraterritorial effects of the new rule.⁶ The SEC received twice as many

[†] B.S., Brigham Young University (2003); M.B.A., Case Western Reserve University Weatherhead School of Management (2006); J.D., Case Western Reserve University School of Law (2006). Recipient of the *Case Western Reserve Journal of International Law* Distinguished Note Award (2005). I would like to thank Andrew Malone for his thoughtful feedback, proofreading, and patience. I would also like to thank Dean Hiram Chodosh and the *Journal of International Law* for their assistance in developing this note. Finally, I would like to thank my dear wife Joy, whose unconditional support made this note possible.

¹ Carrie Johnson, *SEC May Lift Information Restrictions: Changes Proposed to 'Quiet Period' Rules*, WASH. POST, Oct. 27, 2004, at E1.

² See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,055 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279), available at <http://www.sec.gov/rule/final/ia-2333.pdf>.

³ Jesse Eisinger, *Long & Short: SEC Screwdriver Joins Spitzer Hammer as Hedge-Trimmer*, WALL ST. J., Oct. 27, 2004, at C1.

⁴ Stephen Labaton, *Hedge Fund Plan Fractures Civility of Republicans*, N.Y. TIMES, July 16, 2004, at C1.

⁵ *Id.*

⁶ See Letter from David Wright, Dir., European Comm'n, to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n 1 (Sept. 15, 2004) (SEC file number S7-30-04), available at <http://www.sec.gov/rules/proposed/s73004.shtml>.

comment letters from those opposed to the new rule than they received from those in favor of the new rule.⁷

Many Americans reading the headlines were likely left wondering, "What are hedge funds?" and, "Why is everyone so concerned about them?" Hedge funds are legal entities that allow investors to pool their money together, which is then managed by an investment manager who exploits pricing inefficiencies in the market to generate high returns while trying to assume as little risk as possible. Hedge funds are available only to the wealthy because of the high minimum investment required,⁸ which explains why many Americans are not familiar with them.

Hedge funds grew quietly in America for their first thirty five years of existence. Until recently regulators at the SEC, as well as the public, paid little attention to hedge funds. By the early 1990's, hedge funds had grown rapidly, increasing in size to 300 known funds.⁹ By the turn of the century, that number had grown to nearly 6,000.¹⁰ In addition to the rapid growth, one particular hedge fund led to increased public and regulatory scrutiny. In 1998, a hedge fund called Long-Term Capital Management was at the verge of insolvency. Long-Term Capital Management was a highly leveraged hedge fund with an international portfolio that had a market capitalization of over \$3 billion.¹¹ The impending collapse of the fund threatened the stability of international capital markets.¹² In order to avoid this collapse, the president of The New York Federal Reserve Bank, William McDonough, organized a \$3.5 billion bailout of Long-Term Capital Management.¹³ The near collapse of Long-Term Capital Management raised public and regulatory awareness of hedge funds. Following the near collapse of Long-Term Capital Management, the SEC began to research and analyze the hedge fund industry, resulting in the SEC's new rule to regulate hedge funds. The new

⁷ *Recent Developments in the Hedge Fund Industry*, HEDGE FUND NEWSL. (Bryan Cave L.L.P., St. Louis, Mo.), Sept. 30, 2004, at 2, available at <http://www.bryancave.com/pubs/search/asp>.

⁸ The mean minimum investment required in the fourth quarter of 2000 was \$630,729 while the median was \$250,000. The large discrepancy between the mean and median indicates that there is a high degree of variance in the minimum investment requirement among hedge funds. SIMONE BORLA & DENIS MASETTI, *HEDGE FUNDS: A RESOURCE FOR INVESTORS* 13 (2003).

⁹ Erik J. Greupner, Note, *Hedge Funds are Headed Down-market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1561 (2003).

¹⁰ *Id.*

¹¹ See Anita Raghavan & Mitchell Pacelle, *To the Rescue: A Hedge Fund Falters, and Wall Street Giants Ante Up \$3.5 Billion*, WALL ST. J., Sept. 24, 1998, at A1.

¹² Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,174 (proposed July 28, 2004) (to be codified at 17 C.F.R. pts. 275,279).

¹³ See Raghavan & Pacelle, *supra* note 11.

rule requires hedge funds to disclose information about their investment positions and personal information about the manager running the fund.¹⁴

In response to the new rule, hedge fund managers threatened that they would move offshore to avoid registering with the SEC.¹⁵ A mass exodus of hedge funds leaving the United States for offshore financial centers would be detrimental to the U.S. financial market and keep the SEC from accomplishing the purposes of the new rule.¹⁶ It would also result in the loss of talented U.S. fund managers¹⁷ and limit the investment opportunities for American investors.¹⁸ Hedge funds are perfectly able to carry out these threats because all of their assets (cash, investments, and human capital) are very mobile.

On December 10, 2004, the SEC announced that it had approved the proposed rule, making it law.¹⁹ Everyone braced for the worst, expecting many U.S. hedge funds to move offshore when the law went into effect in February of 2005.²⁰

Hedge funds, however, are not moving anywhere. Hedge fund managers will not act on their threat because market conditions, foreign regulators, and provisions of the new rule make moving offshore impractical. The rise in investor power in the hedge fund industry, accompanied by the simultaneous fall in hedge fund manager power, has given investors more power to demand greater transparency from hedge fund managers. The result of the power change is that hedge fund managers cannot avoid disclosure by moving offshore, because their investors will demand disclosure wherever the hedge fund is domiciled. Additionally, many offshore jurisdictions have adopted the SEC's new rule themselves, making it difficult for hedge funds to avoid disclosure by moving offshore.

Section II discusses in detail the precursors that led to the new rule to regulate hedge funds. This section begins by defining hedge funds and explaining the typical investment strategies that hedge funds employ. A

¹⁴ See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,055 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279), available at <http://www.sec.gov/rule/final/ia-2333.pdf>.

¹⁵ Jeff Sommer, *Bermuda Isn't Far, Hedge Funds Warn*, N.Y. TIMES, May 18, 2003, § 3, at 8.

¹⁶ See *id.*

¹⁷ Richard A. Steinwurtzel et al., *SEC Releases Final Rule Requiring Hedge Fund Manager Registration*, 24 BANKING & FIN. SERVICES POL'Y REP. 1 (2005).

¹⁸ Peter O'Leary & Brian McDermott, *Hedge Funds in Ireland—A Review of Developments during 2004 and the Outlook for 2005*, ALTERNATIVE INVESTMENTS MGMT. ASS'N J., Dec. 2004.

¹⁹ See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,054.

²⁰ Sommer, *supra* note 15; Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,054.

description of hedge fund investors and a history of hedge funds are given. Finally, Section II concludes by exploring the modern advancements in hedge funds.

Section III analyzes the history of SEC oversight of the hedge fund industry. Section III then explores the previous exceptions that allowed hedge funds to be exempt from the Securities Act of 1933 and the Investment Advisers Act of 1940. The section finishes by explaining how the new rule closes the exemptions hedge funds had previously enjoyed under the Investment Advisers Act of 1940.

Section IV thoroughly analyzes the new rule. The section begins with a history of why the SEC decided to regulate the hedge fund industry. The problems that the SEC staff sought to solve are identified followed by an analysis of how the new rule helps to alleviate those problems. Next, Section IV evaluates the changes the new rule makes extraterritorially followed by a description of the regulatory climate in Europe and in the Caribbean. Section IV concludes by exploring the extraterritorial effects the new rule has on investors and regulators abroad.

Section V concludes that the threat to move offshore are hollow and outlines the reasons why. The section demonstrates why hedge funds will not move offshore to avoid regulation under the new rule.

II. UNDERSTANDING HEDGE FUNDS

A. Definition of Hedge Funds

Hedging is defined as: "[t]aking a position in two or more securities that are negatively correlated to reduce risk."²¹ This definition of hedge funds would have been an accurate definition of hedge funds in the 1950's and 1960's,²² but today most hedge funds do not hedge in the traditional sense.²³ Most hedge funds today try to exploit temporary price discrepancies in the price of an underlying asset in world financial markets.²⁴

Hedge funds are investment vehicles that employ a variety of investment strategies that historically have avoided regulation. Attempting to define such a loosely related group of unrelated investment vehicles is challenging. The chairperson of the SEC, William Donaldson, in recent testimony before the House Financial Services Committee, said that he was not sure that the SEC would "ever come up with a definition that is broad

²¹ STEPHEN A. ROSS ET AL., CORPORATE FINANCE 262-264 (6th ed. 2002).

²² See Helen Parry, *Hedge Funds, Hot Markets and the High Net Worth Investor: A Case for Greater Protection?*, 21 NW. J. INT'L L. & BUS. 703 (2001); See also BORLA & MASETTI, *supra* note 8, at 2.

²³ See BORLA & MASETTI, *supra* note 8, at xv.

²⁴ Daniel Kadlec, *Will Hedge Funds Take a Dive?*, TIME, Oct. 4, 2004, at 65.

enough or meaningful enough" to define hedge funds.²⁵ Academic legal writers attempt to define hedge funds as, "privately offered, relatively unregulated pooled investment vehicles in the form of limited partnerships or limited liability companies that have the flexibility to invest in a broad range of securities and commodities using a broad range of trading techniques."²⁶ Other common features of hedge funds are high initial investments, a relatively small number of investors, and the ability to invest in a wide range of financial instruments.

When a person invests in a hedge fund structured as a limited partnership, that person becomes a partner with the manager, usually a star trader from Wall Street, causing the investor and the money manager to become co-investors.²⁷ Offshore funds are typically structured as limited liability companies in which the investor is a shareholder, with little or no voting rights.²⁸

The hedge fund industry is young, a recent study of over 2,000 hedge funds revealed that the average hedge fund is only four years old.²⁹ Hedge funds typically attempt to exploit market inefficiencies through temporary price discrepancies in commodity and securities markets.³⁰ Hedge funds exploit market inefficiencies by short selling stock; utilizing sophisticated hedging strategies to reduce interest rate volatility and other risks from market exposure; and using futures contracts or derivatives to leverage their portfolio.³¹ Almost all hedge funds attempt to locate mispriced securities, in differing forms, within the world's financial market; then, using debt, hedge funds expand, or leverage, their positions in the mispriced securities to reap maximum gains for investors while incurring as little risk as possible.³²

²⁵ *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearing Before the SubComm., on Capital Markets, Insurance, and Government Sponsored Enterprises of the Comm. on Financial Services*, 108th Cong. 12 (2003) (statement of William H. Donaldson, Chairman, Securities & Exchange Commission).

²⁶ Greupner, *supra* note 9, at 1559.

²⁷ ROBERT A. JAEGER, ALL ABOUT HEDGE FUNDS: THE EASY WAY TO GET STARTED 7-8 (2003).

²⁸ See STEFANO LAVINIO, THE HEDGE FUND HANDBOOK: A DEFINITIVE GUIDE FOR ANALYZING AND EVALUATING ALTERNATIVE INVESTMENTS 157 (2000).

²⁹ Roy Kouwenberg & William T. Ziemba, Incentives and Risk Taking in Hedge Funds, Workshop at the University of Bergamo in Bergamo, Italy (May 17-21, 2004), available at www.unibg.it/static_content/ricerca/dipartimento_matematica/eumoptfin3_abstract/Ziemba2.pdf.

³⁰ Kadlec, *supra* note 24, at 66.

³¹ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,174 (proposed July 28, 2004) (to be codified at 17 C.F.R. pts. 275,279).

³² See Kadlec, *supra* note 24, at 66.

B. Hedge Fund Investment Strategies

Hedge funds employ three main categories of strategies to generate their returns. These categories are relative value strategies, event driven strategies, and opportunistic strategies. Relative value funds generate returns by extracting profits from the price inefficiencies in specific financial instruments.³³ These price inefficiencies occur when the price of the financial instruments differs from its historical value.³⁴ There are three types of relative value funds: convertible arbitrage funds, fixed income arbitrage funds, and equity market neutral funds. Relative value hedge funds have averaged an annual return of 9.44% with an average annual volatility of 4.07%³⁵ compared with the S&P 500 that had an average return of 10.04% with an average annual volatility of 17.6% during a similar time span.³⁶ The volatility indicates how much the average annual return of the fund fluctuates within any given year within a 95% confidence interval.³⁷ For instance, an average volatility of 4.07% with a return of 9.44% indicates with 95% confidence that in any given year the annual return for a relative value fund will fall between 5.37% and 13.51%.

Event-driven funds take financial positions based on whether a company will or will not go through a structural change. The types of structural changes are mergers, acquisitions, and restructurings.³⁸ While the occurrence of one of these events is uncertain, hedge fund managers will take a long or short position on the stock based upon whether they think the event will occur or not. The risk of each individual position is neutralized by the firm's entire portfolio of positions.³⁹ There are two types of event-driven funds: merger, or risk arbitrage, funds and distressed securities funds.⁴⁰ These funds have an average annual return of 10.67% and an annual average volatility of 6.1%.⁴¹

The final and most controversial grouping of hedge funds is opportunistic funds. This type of fund encompasses a broad range of funds, all of which attempt to manipulate financial markets. This type of strategy is also more risky because it involves speculating rather than hedging.⁴² The funds

³³ See BORLA & MASETTI, *supra* note 8, at 18.

³⁴ *Id.* at 19.

³⁵ FRANCOIS-SERGE LHABITANT, HEDGE FUNDS: QUANTITATIVE INSIGHTS 260 figs.10.12 & 10.13 (2004).

³⁶ *Id.* at 251.

³⁷ See generally ROSS ET AL., *supra* note 21, at 242-76.

³⁸ BORLA & MASETTI, *supra* note 8, at 23.

³⁹ See *id.* at 24.

⁴⁰ *Id.* at 18.

⁴¹ See LHABITANT, *supra* note 35, at 260 figs.10.12 & 10.13.

⁴² See BORLA & MASETTI, *supra* note 8, at 27 tbl.1.8.

that make up this category are macro funds, short selling funds, emerging market funds, long/short funds⁴³ and recently something the market has dubbed long-only funds.⁴⁴ These funds, with the exception of long-only funds, have an average annual return of 7.7% with an annual average volatility of 16.12%.⁴⁵ With the addition of long-only funds, this category will only become riskier. The average return and volatility do not provide the most accurate assessment of this class because of the disparity between the different categories. For instance, the macro fund earned an annual return of 14.5% while fluctuating an average of 13.02% per year, while short selling funds had an average annual return of -1.51% while fluctuating an average of 19.55% a year.⁴⁶

The result of these exotic trading strategies is that hedge funds tend to be market neutral.⁴⁷ Thus, the returns for hedge funds move independently of the stock market. This relationship is important because it allows investors with portfolios to diversify away some of the risk of the investment while maintaining its return.⁴⁸ Hedge funds as a whole typically offer a higher return for risk than traditional asset classes do. However, leading academic Burton G. Malkiel has recently questioned the efficacy of the returns that hedge funds report.⁴⁹ According to Malkiel, relaxed reporting requirements have allowed hedge funds to overstate their actual returns and diversification potential.⁵⁰ Malkiel concludes that hedge funds "are far riskier and provide much lower returns" than the market currently supposes.⁵¹

C. Hedge Fund Investors

Investors invest in hedge funds for a myriad of reasons. The most common reasons that people invest in hedge funds is the superior risk/return tradeoff and the low correlation between hedge funds and the equity markets. From January 1994, to June 2003, hedge funds amassed an average annual return of 10.95% while the corresponding return for the S&P 500

⁴³ *Id.* at 18 fig.1.9.

⁴⁴ See Gregory Zuckerman, *Going Long: Hedge Funds Take the Edge Off*, WALL ST. J., Oct. 29, 2004, at C1.

⁴⁵ See L HABITANT, *supra* note 35, at 260 figs.10.12 & 10.13.

⁴⁶ *Id.*

⁴⁷ See Leon M. Metzger, *Recent Market Events and the Foundation For Global Market Crises: Hedge Funds*, 4 FORDHAM J. CORP. & FIN. L. 5, 15 (1999).

⁴⁸ See ROSS ET AL., *supra* note 21, at 262-64.

⁴⁹ Steve Hays, *Hedge Fund Success May Not Be All it Seems*, REUTERS, Feb. 11, 2005.

⁵⁰ *Id.*

⁵¹ John F. Wasik, *Investing: More Risk, Less Return*, INT'L HERALD TRIBUNE, Nov. 13, 2004, available at http://www.iht.com/bin/print_ipub.php?file=/articles/2004/11/13/minvest13_ed3_.php.

was 10.04%.⁵² What sets hedge funds apart is that despite earning a superior return to that of the S&P 500 they did so while assuming less risk. During the time-period from January 1994 to June 2003, hedge funds displayed an annualized volatility of 9% while the S&P 500 during the same time-period incurred an annualized volatility of 17.6%.⁵³ In an efficient market, a fund that earns an above average return should only be able to do so by assuming an above average amount of risk.⁵⁴ Earning an above average return while assuming less risk means that the fund truly did "beat the market."⁵⁵ Hedge funds are able to generate superior returns while assuming less than average risk during a bear market, bull market, or sideways market.⁵⁶

Another reason that investors invest in hedge funds is the low correlation coefficients between hedge funds and the S&P 500.⁵⁷ A low correlation coefficient means that the two underlying securities, in this case hedge funds and the S&P 500, do not move in unison. This is important to investors because it allows them to earn positive returns regardless of how the stock market is performing. Investors who are looking to diversify their portfolios are looking for investment opportunities with low correlation coefficients because low correlation coefficients allow investors to eliminate the unsystematic risk in their portfolios.⁵⁸ There is modest variation of correlation coefficients among the different investment strategies employed by hedge funds. The short selling funds and fixed income arbitrage funds typically have had the lowest correlation coefficients while event driven funds and long/short funds typically have higher correlation coefficients.⁵⁹ On average, hedge funds have a .18 correlation coefficient during bull markets and a .53 correlation coefficient during bear markets.⁶⁰ This means that hedge funds tend to follow the stock market more when it is increasing but hedge funds do not follow the stock market as strongly when the stock market is decreasing. These low to medium correlation coefficients with the S&P 500, coupled with consistent positive returns, make hedge funds attractive to investors.

Hedge fund investors are divided into two categories: individual investors and institutional investors. Individual investors are further divided

⁵² LHABITANT, *supra* note 35, at 251.

⁵³ *Id.* at 251 fig.10.2.

⁵⁴ See generally ROSS ET AL., *supra* note 21.

⁵⁵ *Id.*

⁵⁶ Lodovico Gandini, *Benefits of Allocation of Traditional Portfolios to Hedge Funds*, Spring, 2004, available at <http://www.aima.org/uploads/Gandini.pdf>.

⁵⁷ LHABITANT, *supra* note 35, at 253.

⁵⁸ See ROSS ET AL., *supra* note 21, at 245-249, 262-264.

⁵⁹ See FRANCOIS-SERGE LHABITANT, HEDGE FUNDS: MYTHS AND LIMITS 171 tbl.14.9 (2002).

⁶⁰ *Id.*

into U.S. investors and foreign investors. Foreign investors are typically interested in offshore funds so they can avoid U.S. taxes.⁶¹ U.S. investors' assets are divided into taxable and tax exempt assets. U.S. investors looking to invest taxable assets typically will look to invest in onshore hedge funds, while investors with tax-exempt assets will typically look to offshore funds for their tax advantages. Individual investors are comprised almost entirely of high-net-worth individuals.⁶² Institutional investors are also divided into taxed and tax-exempt institutions. Taxable institutions like banks, insurance companies, and other investment funds typically invest in onshore funds, while tax-exempt institutions like pension funds, endowments, and charitable foundations typically invest in offshore funds.⁶³ U.S. hedge funds are comprised of 45% individual investors, 20% tax-exempt institutional investors, and 30% taxable institutional investors while offshore hedge funds are comprised of 35% individual investors, 30% tax-exempt institutional investors, and 30% taxable institutional investors.⁶⁴

D. History of Hedge Funds

The emergence of hedge funds as serious players in financial markets is a recent phenomenon. Alfred Jones created the first hedge fund in 1949.⁶⁵ He employed a strategy consisting of using leverage and long and short selling to produce positive returns in both up and down markets.⁶⁶ More specifically, he took "long positions in undervalued stocks and short positions in overvalued stocks with a modest element of leverage."⁶⁷ Between 1955-1965 Mr. Jones's fund had a higher rate of return, 670%, than any other fund in the world.⁶⁸

During the 1940's, 50's and 60's, hedge funds only used leverage and short selling to hedge their stock portfolio's movement in the equity markets.⁶⁹ Through the 1970's and 80's hedge funds became more complex and risky.⁷⁰ Some hedge funds continued to take long positions in the market but utilized less short positions.⁷¹ The increased reliance on long positions caused hedge funds to be more risky, which was only exasperated by

⁶¹ JAEGER, *supra* note 27, at 36-37.

⁶² *Id.* at 34.

⁶³ *Id.*

⁶⁴ LHABITANT, *supra* note 35, at 11.

⁶⁵ Greupner, *supra* note 9, at 1560.

⁶⁶ *Id.*

⁶⁷ Parry, *supra* note 22, at 703.

⁶⁸ BORLA & MASETTI, *supra* note 8, at 2.

⁶⁹ Carol J. Loomis, *Hard Times Come to the Hedge Funds*, FORTUNE, Jan. 1970, at 100.

⁷⁰ See JAEGER, *supra* note 27, at 29-32.

⁷¹ See generally Loomis, *supra* note 69.

their increased use of leverage.⁷² During this time-period, new types of hedge funds were born that relied on different investment strategies.⁷³ At the same time, hedge funds became more popular because of the high returns they were able to offer.

The 1990's saw an exponential rise in the number of hedge funds as wealth grew and initial investment requirements fell. During this time period, there was exponential growth in the types of strategies that hedge funds employed.⁷⁴ As competition grew within the industry, traditional strategies no longer offered high returns; forcing hedge fund managers to look to new strategies to generate returns.⁷⁵ By the late 1990's, hedge funds had become so popular that they were no longer virtually unknown investment funds.

E. Modern Advancements in Hedge Funds

This once unregulated pooled investment tool is now coming under increased scrutiny and regulation. The increased scrutiny of hedge funds is the result of the rapid growth of hedge funds over the last decade. Before 1990, there were approximately 300 known hedge funds; since 1990, that number has grown to over 6,000.⁷⁶ In 2004, the U.S. hedge fund industry grew by 19% to \$973 billion, up from \$820 billion in 2003.⁷⁷ Hedge funds are growing at a rate of 15-20% per year and currently have assets under management of approximately \$1 trillion in the U.S.⁷⁸

Today, hedge funds play a key part in ensuring the efficiency of our markets. The chairperson of the Managed Fund Association, Adam Cooper, testifying before Congress said: "[h]edge funds act as 'risk absorbers' in [our financial] markets by serving as ready counterparties to those wishing to hedge [their] risk, even when [the] markets are volatile. In addition their active trading and research contribute to greater pricing efficiencies in our financial markets."⁷⁹ Hedge funds use arbitrage to exploit mispriced assets in our global markets. Hedge funds do this by buying an asset in one market then simultaneously selling an identical asset in another market at a higher

⁷² *Id.*

⁷³ See JAEGER, *supra* note 27, at 29-32.

⁷⁴ See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,174 (proposed July 28, 2004) (to be codified at 17 C.F.R. pts. 275,279).

⁷⁵ Zuckerman, *supra* note 44.

⁷⁶ Greupner, *supra* note 9, at 1561.

⁷⁷ Ben Wright, *US Hedge Funds to Top \$1 Trillion*, BUS. ONLINE, Jan. 30, 2005, at A1.

⁷⁸ Kadlec, *supra* note 24, at 65.

⁷⁹ *Regulation of the Hedge Fund Industry: Hearing Before the Sen. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. 2 (2004) (statement of Adam C. Cooper, Chairman, Managed Fund Association).

price.⁸⁰ Once a hedge fund identifies a mispriced asset, it will take advantage of the opportunity until the price corrects itself. Hedge funds take such a large position in the asset that its own trading activity quickly corrects the price. As more hedge funds correct prices in global markets, prices become more accurate and the markets become more efficient.

III. HEDGE FUND REGULATION

A. History of SEC's Oversight of Hedge Funds

Traditionally, the U.S. has not regulated hedge funds. However, "the Commission has long been concerned about hedge funds and their managers, and the impact their investment activities can have on" the country's financial markets.⁸¹ The SEC first began to look at the impact of hedge funds as early as 1969.⁸² In 1971 the SEC conducted an economic study in which the Commission "described the activities of hedge funds, noted the serious conflicts of interest that hedge fund advisers ha[d], and noted their growth."⁸³ At that time the hedge fund industry was still small and seemed to have a negligible effect on U.S. markets. For the next twenty years, the SEC paid little interest to the hedge fund industry. All of this changed with the Long-Term Capital Management debacle.

In the mid-1990's Long-Term Capital Management (LTCM) was a large, highly leveraged hedge fund that employed two Nobel Prize winning economists and a host of Ph.Ds.⁸⁴ The fund's investment strategy used complex models to take advantage of arbitrage opportunities throughout the world's financial markets.⁸⁵ In August 1998, Russia's unexpected financial crisis caused the unraveling of this highly leveraged fund, which threatened the stability of international bond markets.⁸⁶ To avoid the impending fallout the president of The New York Federal Reserve Bank, William McDonough, orchestrated a bailout among prominent banks to save LTCM.⁸⁷ Although LTCM was saved from insolvency, the hedge fund in-

⁸⁰ See generally ROSS ET AL., *supra* note 21.

⁸¹ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,174 (proposed July 28, 2004) (to be codified at 17 C.F.R. pts. 275,279).

⁸² *Id.* at 45,174.

⁸³ *Id.*

⁸⁴ ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT xix, 31 (2001).

⁸⁵ Jonathan H. Gatsik, Note, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV. 591, 599 (2001).

⁸⁶ PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 12 (Apr. 28, 1999), available at <http://www.ustreas.gov/press/releases/reports/hedgfund.pdf>.

⁸⁷ Raghavan & Pacelle, *supra* note 11.

dustry was thrust into the national spotlight. The media coverage forced the U.S. Congress and those in the investment community to consider greater regulation of the hedge fund industry.

In 1999, the SEC and the President's Working Group on Financial Markets conducted a study of the hedge fund industry.⁸⁸ In 2002, the SEC directed its staff to once again examine the activities of hedge funds and determine the number and size of hedge funds; document cases of fraud involving hedge funds; and document the activities of hedge funds that might affect a broader group of people other than wealthy individuals and families that had traditionally invested in hedge funds.⁸⁹ At the conclusion of this study, the SEC staff published a report entitled *Implications of the Growth of Hedge Funds*, where the Commission found that the growth of hedge funds raised a number of public policy concerns, most notably the issue of investor protection.⁹⁰ This report was a precursor to the new rule to regulate hedge funds.

B. Previous Regulation of Hedge Funds

Previously, most hedge funds were able to circumvent most regulation through a series of exemptions and safe harbors built into the 1933 Securities Act and the 1940 Investment Advisers Act.⁹¹ Hedge funds avoided registration under the 1933 Act by relying on the Section 4(2) exemption that applies to firms that sell securities through a nonpublic offering to sophisticated investors.⁹² Congress enacted the exemption to allow issuers to avoid registration requirements when the public was not privy to the issue and therefore would not benefit from the registration.⁹³ The sophisticated investor standard was molded into the accredited investor concept in the Supreme Court's decision in *SEC v. Ralston Purina Co.*⁹⁴ The Court indicated that the exemption for nonpublic offerings would depend on whether or not the offerees are considered accredited under the Act, meaning the offerees have to be sophisticated enough to obtain and analyze the financial

⁸⁸ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45,174.

⁸⁹ *Id.*

⁹⁰ U.S. SEC. & EXCH. COMM'N, STAFF REPORT TO THE U.S. SEC. & EXCH. COMM'N: IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, at x (2003), reprinted in DANFORTH TOWNLEY, UNDERSTANDING HEDGE FUNDS & PENDING REGULATION: WHAT YOU NEED TO KNOW NOW 147 (2004) [hereinafter *SEC Staff Report*].

⁹¹ Greupner, *supra* note 9, at 1583-84, 1586.

⁹² *Id.* at 1584; see also 17 C.F.R. § 230.501 (1999) (defining "accredited investors").

⁹³ Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 689 (2000).

⁹⁴ See Sec. & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953).

data from the offeror that would be disclosed in registration.⁹⁵ The Court noted that such persons, because of their knowledge, would not have to rely on the protections resulting from registration.⁹⁶ The high-wealth-individuals and families that typically invest in hedge funds must have the requisite knowledge and access to information that meets the statutory categories of accredited investors contained in Reg. D of the 1933 Act.⁹⁷ This allows hedge funds which offer nonpublic offerings to be exempt from the 1933 Act.

Most hedge funds are able to qualify for an exemption to the 1940 Investment Advisers Act through the use of sections 3(c)(1), 3(c)(7), and 203(b)(3).⁹⁸ Hedge funds attempting to circumvent registration under these exceptions must sell to either no more than 99 accredited investors or no more than 499 qualified purchasers.⁹⁹

Exemption 203(b)(3), the private investment adviser exemption, allows an exemption for funds with less than fifteen clients.¹⁰⁰ A client can be a person, a limited partnership, or a limited liability company that allows the fund to invest its money using the hedge fund's investment strategy.¹⁰¹ As long as a hedge fund has less than fifteen limited liability companies or limited partnerships investing in it, it is exempt from the 1940 Act. After the 203(b)(3) exemption, a hedge fund must only satisfy the net worth requirements of exceptions 3(c)(1) and 3(c)(7) in order to be completely exempt from registering under the 1940 Act.¹⁰²

The section 3(c)(1) exemption exempts "any investment vehicle with no more than 100 beneficial owners that does not make" a public offering of its securities.¹⁰³ Hedge funds are typically structured to qualify for this exclusion.¹⁰⁴ Section 3(c)(7) exempts any investment company that only sells to qualified purchasers and does not make any public offerings.¹⁰⁵ A qualified purchaser is any individual or family-owned company with more than \$5 million in investments or certain trusts and any other person that has at least \$25 million in investments.¹⁰⁶ Most hedge funds allow only quali-

⁹⁵ See *id.*

⁹⁶ *Id.* at 124-26.

⁹⁷ See 17 C.F.R. § 230.501.

⁹⁸ Greupner, *supra* note 9, at 1587.

⁹⁹ *Id.* Qualified purchasers are individuals with a net worth of at least \$5 million. *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12-13 (1971).

¹⁰⁰ Investment Advisers Act, 15 U.S.C. § 80b-3(b)(3) (2000).

¹⁰¹ 17 C.F.R. § 275.203(b)(3)-1(a) (2005).

¹⁰² See Greupner, *supra* note 9, at 1587.

¹⁰³ 15 U.S.C. § 80a-3(c)(1) (2000); see also Gibson, *supra* note 93, at 694.

¹⁰⁴ Gibson, *supra* note 93, at 694.

¹⁰⁵ *Id.* at 695.

¹⁰⁶ *Id.* at 695-96.

fied purchasers to enter their funds. The exemptions from the 1933 and 1940 Act allowed hedge funds to avoid any required public disclosures or regulation. Because of these exemptions, U.S. oversight of hedge funds consisted of anti-fraud statutes and a judicially enforced fiduciary duty to investors. The hedge fund industry was able to exist, almost regulation free, within the heavily regulated investment community.

The Commodities Future Trading Commission (CFTC) also regulates hedge funds. The CFTC regulates transactions in futures and commodity options.¹⁰⁷ Investment funds that trade in futures or commodities are classified as commodity pools that are subject to regulation.¹⁰⁸ The CFTC defines a commodity pool as "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests."¹⁰⁹ Most hedge funds qualify as a commodity pool.¹¹⁰ Very few hedge funds qualify for an exemption from CFTC oversight. The one exemption that some hedge funds take advantage of is CFTC Rule 4.5. This rule provides an exemption for commodity pools regulated by other federal or state law.¹¹¹ Hedge funds that utilize this exemption usually operate offshore.¹¹² In order to qualify for this exemption, the hedge fund must be domiciled in a home country that regulates its futures and commodity trading and must have entered into a satisfactory memorandum of understanding with the CFTC.¹¹³

CFTC Rule 4.7 grants funds who do not qualify for an exemption, exemptive relief from full reporting to the CFTC.¹¹⁴ Rule 4.7 lists commodity pools that qualify for this exemptive relief.¹¹⁵ Most hedge funds structure themselves to qualify for this exemptive relief.¹¹⁶ The exemptive relief allows hedge funds to avoid disclosing their positions to investors and preparing quarterly and annual financial statements.¹¹⁷

¹⁰⁷ *Id.* at 699.

¹⁰⁸ *Id.*

¹⁰⁹ 17 C.F.R. § 4.10(d)(1) (2005).

¹¹⁰ Gibson, *supra* note 93, at 700.

¹¹¹ 17 C.F.R. § 4.5 (2005).

¹¹² Brooksley Born, *International Regulatory Responses to Derivatives Crises: The Role of the U.S. Commodity Futures Trading Commission*, 21 NW. J. INT'L L. & BUS. 607, 610-611 (2001).

¹¹³ *Id.* at 610-11.

¹¹⁴ Gibson, *supra* note 93, at 702-03.

¹¹⁵ See 17 C.F.R. § 4.7(a)(2); see also Gibson, *supra* note 93, at 702 (providing an excellent description of qualifying commodity pools).

¹¹⁶ See Gibson, *supra* note 93, at 702-03.

¹¹⁷ *Id.* at 702-03.

C. Proposed New Rule

In its most basic sense, the SEC's new rule cuts out the exemptions to the 1940 Act that hedge funds had previously enjoyed. The new rule closes exceptions 3(c)(1), 3(c)(7), and 203(b)(3) to hedge funds. How does the new rule do this? It closes exceptions 3(c)(1) and 3(c)(7) of the 1940 Act to hedge funds by changing the definition of a "private fund" that the adviser would be required to "look through."¹¹⁸ It does this by referencing within the definition of a "private fund" three characteristics shared by virtually all hedge funds.¹¹⁹ This requirement forces hedge fund managers to "look through" their fund to count U.S. clients.¹²⁰

The new rule will also require hedge fund managers to disclose information about them.¹²¹ These new disclosures include the fund's history, personnel experience, past performance, and disciplinary record.¹²² Additionally, advisers making claims concerning their "track record" must keep documentation supporting these performance claims.¹²³

Exception 203(b)(3)-2 is amended to require investment advisers to count each owner of a "private fund" as a client for purposes of determining the availability of the private adviser's exemption.¹²⁴ Under the previous rule, hedge funds could create separate limited partnerships, which would count as one client but serve as conduits for groups of investors.¹²⁵ As long as a fund had placed its investors in less than fifteen subsidiary funds, the hedge fund could avoid registration with the Investment Advisers Act of 1940.¹²⁶ Exception 203(b)(3)-1 is amended to clarify that investment managers "may not count hedge funds as single clients under that safe harbor [rule]."¹²⁷ Rather than counting entities in their hedge fund, investment advisers are now required to count each individual investor in their fund before they can claim the 203(b)(3) exception for having less than fifteen investors.¹²⁸

¹¹⁸ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,073 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.* at 72,075.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.* at 72,070.

¹²⁵ Gibson, *supra* note 93, at 697-98.

¹²⁶ *Id.*

¹²⁷ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,075.

¹²⁸ *Id.*

The rule does not alter Rule 203A-1 of the Investment Advisers Act of 1940. If an adviser maintains its principal office in a state with an investment adviser statute, registration is optional if the adviser has less than \$25 million under management. This provides an exception for small offshore funds.¹²⁹

The new rule contains also alters the exceptions for offshore advisers. When counting clients for the 203(b)(3) exception, an offshore hedge fund manager now has to look through to the funds she manages, regardless of where those funds are located, and count investors that are U.S. residents as clients.¹³⁰ An offshore fund with more than fourteen investors who are U.S. residents would generally have to register under the 1940 Investment Advisers Act.¹³¹ However, "offshore advisers" would generally not be subject to the substantive provisions of the Act under the new rule.¹³² The SEC staff explains, "[t]he [substantive] laws governing such a fund would likely be those of the country in which it is organized or those of the country in which the adviser has its principal place of business."¹³³ Essentially, the SEC reached a compromise position in the new rule's extraterritorial application. The new rule requires hedge funds subject to the rule changes to register with the SEC, but it does not require "offshore advisers" to adhere to the substantive provisions of the 1940 Investment Advisers Act.

Registration requires "hedge funds to disclose information such as their trading strategy, the amount of money they manage," and the manager's disciplinary history.¹³⁴ Also required under the new regulation is a description of who its clients are, the educational and business background of those running the fund, and audited financial statements prepared in accordance with generally accepted accounting principles.¹³⁵ Finally, hedge funds subject to the new rule will have to adopt a code of ethics and implement a compliance program.¹³⁶

¹²⁹ See Steinwurtzel et al., *supra* note 17, at 2 n.1.

¹³⁰ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,071-72.

¹³¹ *Id.*

¹³² *Id.* at 72,072.

¹³³ *Id.* at 72,072 n.213.

¹³⁴ Kadlec, *supra* note 24, at 65.

¹³⁵ Elizabeth M. Schubert, *A Compliance Guide to the Investment Advisers Act of 1940*, HEDGEWORLD.COM, Oct. 20, 2004, <http://www.mfainfo.org/images/PDF/HedgeWorld.pdf>.

¹³⁶ Schubert, *supra* note 135, at 66.

IV. ANALYSIS OF THE NEW RULE

A. Problems the New Rule is Designed to Alleviate

The SEC's new rule emanates from the Commission's concern that the lack of transparency within the hedge fund industry could harm individual investors and the overall market.¹³⁷ The SEC was also concerned about the risk of systematic loss that hedge funds posed, the effects hedge funds were having on world financial markets, and the growth in hedge fund fraud.¹³⁸ The SEC revised the Investment Advisers Act of 1940 to alleviate some of these concerns.

Previously, hedge funds had been exempt from the disclosure requirements of the Investment Advisers Act.¹³⁹ Many hedge funds provided minimal information about themselves, leaving investors in the dark about the fund's holdings.¹⁴⁰ Investors, unable to evaluate the fund, put their trust in the manager to continue to generate high returns while assuming minimal amounts of risk. The SEC did not require hedge funds to provide information to its investors, assuming that high-net-worth individuals who invested in hedge funds were sophisticated enough to determine the risks and rewards associated with a given investments.¹⁴¹

However, as hedge funds became more complex, this assumption did not always hold true. Many hedge funds invested heavily in over the counter (OTC) derivative products, which are not regulated.¹⁴² OTC products are complex enough that "even financially sophisticated investors may lack the expertise" to understand these transactions.¹⁴³ This made it even harder for investors to have the information necessary to make informed, rational investment decisions about hedge funds.¹⁴⁴

Further weakening the SEC's assumption about the knowledge of wealthy investors is the influx of newly wealthy investors. These individuals, whose wealth was created recently, are entertainers, sports stars, and "dot com" entrepreneurs.¹⁴⁵ Although wealthy, they tend to lack the requisite knowledge to make informed investment decisions. Newly wealthy

¹³⁷ SEC Staff Report, *supra* note 90, at 152.

¹³⁸ *Id.*

¹³⁹ Greupner, *supra* note 9, at 1587.

¹⁴⁰ Gregory Zuckerman & Ian McDonald, *The Wild West of Hedge Funds Becomes Tamer*, WALL ST. J., Jan. 24, 2005, at C1.

¹⁴¹ Sec. & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953).

¹⁴² Parry, *supra* note 22, at 706-07.

¹⁴³ Gibson, *supra* note 93, at 713.

¹⁴⁴ See Zuckerman & McDonald, *supra* note 140.

¹⁴⁵ Parry, *supra* note 22, at 719.

investors are ripe targets for unscrupulous hedge fund advisers.¹⁴⁶ The new rule the SEC has implemented requires greater disclosure to investors helping to alleviate problems of information asymmetry.

Another concern of the SEC staff is the risk of systematic loss that hedge funds pose to the world's financial markets. Systemic loss refers to the risk that a major market participant's losses in the financial markets may cause widespread loss to other firms in the market, or cause disruptions to other industries or to the entire worldwide financial system.¹⁴⁷ The bailout of LTCM was orchestrated to avoid the possibility of systemic loss in the world's financial markets.¹⁴⁸ Although systemic risk is always a concern in financial markets, it can be minimized if lenders exercise prudent judgment in making credit decisions.¹⁴⁹ Prudent judgment by creditors is important because hedge funds use varying degrees of leverage to amplify their returns. Their leverage typically comes from credit extended to them from banks. Banks have the responsibility to limit systemic risk by performing risk analysis before they extend credit and pricing the credit according to the risk the fund poses.¹⁵⁰ However, in the case of hedge funds, banks have difficulty in assessing an accurate interest rate because of the lack of transparency among hedge funds. Banks cannot make accurate risk assessments without adequate disclosure from hedge funds. When banks are competing to make loans, they tend to lower their credit standards in an attempt to make more loans. The disclosure requirements of the new rule will assist banks in making accurate risk assessments of hedge funds, thereby preventing the risk of systematic loss.

Also assisting to reduce the risk of systemic loss are large institutional investors. These investors demand more information from hedge funds about their trading positions and degree of leverage. Previously, it was common for hedge funds to borrow \$10 for every \$1 it held.¹⁵¹ Today, institutional investors typically do not allow managers to leverage at a ratio higher than four to one.¹⁵² Institutional investors are able to have this type of influence over hedge fund managers because institutional investors contribute more than half of the hedge funds' assets.¹⁵³

¹⁴⁶ *Id.*

¹⁴⁷ Gibson, *supra* note 93, at 705.

¹⁴⁸ LOWENSTEIN, *supra* note 84, at xix-xx.

¹⁴⁹ See Gibson, *supra* note 93, at 706-08.

¹⁵⁰ U.S. GEN. ACCOUNTING OFFICE, REP. TO CONG. REQUESTERS, GAO/GGD-00-3, LONG-TERM CAPITAL MANAGEMENT: REGULATORS NEED TO FOCUS GREATER ATTENTION ON SYSTEMATIC RISK 11 (1999), <http://www.gpoaccess.gov/gaoreports/search.html/>.

¹⁵¹ Zuckerman & McDonald, *supra* note 140.

¹⁵² See *id.*

¹⁵³ See LHABITANT, *supra* note 35, at 11.

Before the new rule, regulators did not have the information necessary to determine the effects hedge funds were having on financial markets.¹⁵⁴ Not only did regulators not know the positions held by hedge funds, but they also did not know the systemic risk that hedge funds were posing to the markets because many hedge funds borrowed from international banks not regulated by the United States.¹⁵⁵ The disclosure provided by the new rule allows regulators to determine the position hedge funds have taken; thereby assisting regulators in determining the risk hedge funds pose to the markets.

B. Extraterritorial Analysis of Changes to the Investment Advisers Act of 1940

A key difference between the old and new rule is that the new rule requires that offshore funds "look through" their clients and determine if the fund has more than fourteen American investors.¹⁵⁶ If the fund has more than fourteen American investors, the fund must register with the SEC.¹⁵⁷ Offshore funds opposed this rule change claiming that they are already adequately regulated by their home country, and that this regulation does nothing but cause duplicative regulation.¹⁵⁸ To minimize the offshore funds' concern, the SEC exempted publicly offered funds from the new rule and exempted private offshore funds that are adequately regulated in their home countries from the substantive provisions of the new rule.¹⁵⁹ However, hedge funds would still have to go through the expense of looking through their clients each year and make the mandatory disclosures to the SEC if they have more than fourteen U.S. investors and its home country's hedge fund regulations are deemed inadequate by the SEC staff. Hedge funds that have to register under the new rule can anticipate the cost of compliance to be around \$376,500.¹⁶⁰

¹⁵⁴ SEC Staff Report, *supra* note 90, at 152.

¹⁵⁵ Barry Eichengreen & Donald Mathieson, *Hedge Funds: What Do We Really Know?*, Int'l Monetary Fund, 19 ECON. ISSUES 11 (1999), available at <http://www.imf.org/external/pubs/ft/issues/issues19/index.htm>.

¹⁵⁶ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,071-72 (Dec. 10, 2004) (to be codified at 17 CF.R. pts. 275, 279).

¹⁵⁷ *Id.*

¹⁵⁸ See Letter from Christopher Fawcett, Chairman & Dermont Butler, Deputy Chairman, Alternative Inv. Mgmt. Ass'n Ltd., to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n, 7 (Sep. 15, 2004), available at <http://www.sec.gov/rules/proposed/s73004/aima091504.pdf>.

¹⁵⁹ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,071-72.

¹⁶⁰ The cost of compliance is estimated by the SEC to be \$46,000 with an annual increased workload of 1,469 to be shouldered by the hedge fund's counsel. The cost of counsel is estimated to be \$225 an hour. See Letter from Bryan Cave, LLP, to Jonathan G. Katz, Sec'y,

The exemption from the substantive provisions of the Investment Advisers Act for offshore hedge funds has still not resolved the problem of double registration for many hedge funds. The European Commission, which administers EU investment regulations, is still concerned that European hedge funds that are subject to stringent regulation in Europe would have to register with the SEC as well because they have a small, minority number of U.S. investors.¹⁶¹ Such double registration increases the cost for European hedge funds, placing them at a disadvantage compared to American hedge funds that are subject only to SEC oversight. The International Bar Association (IBA) claims that the application of American securities law abroad violates the rule of international comity: "[I]n cases where the U.S. jurisdictional interest is not as great as that of another jurisdiction it would be appropriate to defer to that foreign jurisdiction to enforce and protect the rights of its own citizens."¹⁶² The Third Restatement of Foreign Relations states that a nation has jurisdiction when part of the conduct takes place within the territory of that nation or when the conduct affects nationals of that nation.¹⁶³ Although principles of comity do suggest that the SEC might be wise to defer to adequate foreign regulators when applicable, thereby minimizing costs for offshore funds, it is unlikely that a U.S. court would strike down this regulation as violating international law. The SEC staff concluded that this proposal was not feasible for the SEC to adopt because it would require the SEC staff to determine the regulatory requirements of hundreds of nations and monitor them on an ongoing basis for changes in the laws of these nations.¹⁶⁴ The SEC staff claims that such a rule would unnecessarily tax the resources of the SEC.¹⁶⁵ The SEC prefers to establish a "single set of rules [that] assures a level playing field for both U.S. and foreign participants in [U.S.] markets."¹⁶⁶

To minimize the costs for offshore hedge funds, the International Bar Association (IBA) has proposed an alternative to counting clients. The IBA proposes that rather than having a hedge fund manager look through

U.S. Sec. & Exch. Comm'n, 16 (Aug. 16, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/bryancave081604.pdf>.

¹⁶¹ Letter from David Wright to Jonathan G. Katz, *supra* note 6, at 3.

¹⁶² Letter from Robert W. Helm, Vice Chair, Int'l Bar Ass'n, to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n, 3 (Sept. 14, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/rwhelm091404.pdf>.

¹⁶³ RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 402 (1987); *see also* Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 993 (2d Cir. 1975), *cert. denied*, 423 U.S. 1018 (1975).

¹⁶⁴ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,071.

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

their fund to determine if they have more or less than fourteen American investors, the SEC should apply the "significant participation test" from ERISA law.¹⁶⁷ The "significant participation test" says that a fund manager should not have to look through its funds "if less than 25% of the value of any class of equity interests in the private fund is held by 'U.S. residents.'"¹⁶⁸

The rationale behind this proposal is that the SEC's requirement that all offshore hedge funds look through their records to determine if they have more than fourteen American investors is expensive. The "look through" process causes funds to incur costs regardless of the number of American investors they find they have. For large funds with hundreds or thousands of investors, it can be costly to have to comply with U.S. regulations when the regulation might be triggered by less than 1% of the fund's shareholders. The other 99% of shareholders, or partners, will have to sustain a substantial increase in costs to comply with a regulation designed to protect only 1% of shareholders. The 25% of assets rule ensures that regulation will only be applied when a sizeable percentage of the fund's assets have been contributed by U.S. residents.

The problem with the IBA proposal is that it does not accomplish the purposes of the new rule.. The "significant participation test" would encourage regulatory arbitrage. Onshore funds would be able to move offshore and avoid regulation as long as more than 75% of its assets come from foreign investors. This would prevent the SEC staff from receiving information from hedge funds to determine the effect they are having on the financial markets. The IBA proposal would also allow hedge funds to avoid disclosing more information to their investors. The SEC responded to this proposal by stating: "[w]e believe that this suggestion would result in most offshore advisers that serve U.S. investors being exempt from registration, and we are not adopting it."¹⁶⁹

C. Extraterritorial Principles Incorporated into the New Rule

The SEC traditionally has justified the extraterritorial application of American securities law through the effects test of the territoriality principle and the nationality principle.¹⁷⁰ The effects test of the territoriality principle

¹⁶⁷ Letter from Robert W. Helm to Jonathan G. Katz, *supra* note 162, at 2.

¹⁶⁸ *Id.* at 1.

¹⁶⁹ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,072.

¹⁷⁰ RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 416 cmt. a (1987); see also Michael D. Mann et al., *Oversight by the U.S. Securities and Exchange Commission of U.S. Securities Markets and Issues of Internationalization and Extraterritorial Jurisdiction*, 29 INT'L LAW. 731, 731 (1995) (discussing motives for U.S. subject matter jurisdiction over international securities transactions).

occurs when a country applies its laws abroad because the activity occurring abroad has substantial effects within the country's territory.¹⁷¹ The effects test has been controversial when applied to conduct that was legal in the country the conduct occurred in but illegal in the U.S. When the U.S. extends its jurisdiction in these cases because that conduct had negative economic effects within the U.S., the country where the conduct took place typically objects to the extension of U.S. law to its soil.¹⁷² Less controversial is the nationality principle. Under the nationality principle, the U.S. extends its jurisdiction on the basis that the individuals involved in the activity abroad are U.S. residents.¹⁷³ The U.S. can extend its jurisdiction to corporations organized in the U.S. conducting business abroad, by using the nationality principle.¹⁷⁴

The SEC's new rule to regulate hedge funds extends extraterritorially by requiring hedge funds located abroad to register with the SEC if they have more than fourteen American investors. The new rule bases its extraterritorial application on the nationality principle. The rule applies extraterritorially based on the nationality of those investing in the hedge fund. Once fifteen U.S. investors invest in the hedge fund, it must register with the SEC. The new rule also seems to draw slightly from the effects test of the territorial principle, because the new rule does not become effective based on nationality until the requisite number of U.S. investors are present. The arbitrary number of fourteen chosen by the SEC seems based on the theory that when a certain number of U.S. investors invest in a hedge fund it has an economic effect on the U.S. Alternatively, the basis for utilizing the standard of fourteen U.S. investors could be based on the theory that when a foreign hedge fund accepts money from more than fourteen U.S. investors, the fund has adopted a distinctively U.S. clientele and thus should comply with U.S. securities law.

Regardless of whether or not the effects test of the territorial principle is invoked, one effect of utilizing the nationality principle to apply U.S. securities law extraterritorially is that this could limit investment and diversification opportunities for U.S. investors. Foreign hedge funds seeking to avoid the regulatory hassle of SEC registration will likely not allow more than thirteen U.S. investors to invest in its funds. If many foreign hedge funds adopt this approach, the number of investment opportunities for American investors will be limited. However, hedge funds will only avoid American investors if it is economically viable to do so. If economic forces

¹⁷¹ RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 416 cmt. d (1987).

¹⁷² *Id.*

¹⁷³ *Id.* § 402 cmt. e (1987).

¹⁷⁴ *Id.*

dictate, foreign hedge funds will not avoid American investors and will likely register with the SEC.

D. Regulatory Approaches to Hedge Funds Taken by other Nations

The SEC is not the first regulatory authority to regulate hedge funds.¹⁷⁵ Countries across the globe have taken a variety of approaches to regulate hedge funds ranging from no regulation at all, to barring hedge funds entirely.¹⁷⁶ The two most popular places to domicile a hedge fund, other than the United States, are Europe and the Caribbean.¹⁷⁷

Europe is a popular place for hedge funds because of the relatively high population of high-net-worth individuals. The laws regulating hedge funds in the United Kingdom, Ireland, Switzerland, France, and Germany provide a good perspective of the differing approaches taken to hedge fund regulation in Europe.

In the United Kingdom, the Financial Services Act of 1986 regulates hedge funds.¹⁷⁸ The Act prohibits fund managers from advising investors "to enter into investments that are not suitable for them in their circumstances."¹⁷⁹ Clients can choose to contract out of this protection and agree to be classified as an expert investor if they have a sufficient understanding of the investment opportunity and have previous experience with the specific investment.¹⁸⁰ The Financial Services and Markets Act of 2000 prohibits hedge funds, or other unregulated collective investment schemes, from marketing their product to investors, unless the individual is an expert investor.¹⁸¹ The main difference between the U.S. and U.K. definition of a sophisticated investor is that the British version of a sophisticated, or expert, investor pertains to that investor's knowledge and experience, while the American version refers to the investor's wealth.

Ireland has become a popular domicile for hedge funds in Europe because of the tax and regulatory advantages of domiciling in Ireland.¹⁸² Hedge funds in Ireland are regulated by the Irish Financial Services Regulatory Authority (IFSRA).¹⁸³ The IFSRA has sped up their regulatory process to compete with other regulatory authorities, specifically those in the Cay-

¹⁷⁵ See generally, BORLA & MASETTI, *supra* note 8, at 57-78 (describing countries that currently regulate hedge funds).

¹⁷⁶ *Id.*

¹⁷⁷ See *id.* at 8.

¹⁷⁸ See Parry, *supra* note 22, at 707.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 705 n.8, 708.

¹⁸² See O'Leary & McDermott, *supra* note 18, at 1.

¹⁸³ *Id.*

man Islands that offer quick and non-intrusive regulation of hedge funds.¹⁸⁴ Hedge funds are subject to taxation in Ireland, but at a low rate of 10%.¹⁸⁵ Ireland is also popular among hedge funds because the Irish Stock Exchange lists collective investments schemes. These collective investment schemes are comprised primarily of onshore and offshore hedge funds.¹⁸⁶ The Irish Exchange is the leading stock exchange in the world for listing hedge funds.¹⁸⁷ Popularity of hedge funds in Ireland should only increase because of proposed changes in the European Union that would allow funds domiciled in Ireland to be sold throughout the European Union without being subjected to each member country's regulation.¹⁸⁸ Hedge funds choose to domicile in Ireland because of the low tax rate, lax regulation, proximity to London, and access to an exchange.¹⁸⁹

Switzerland's ability to attract hedge funds is directly related to its banking industry's ability to attract high-net-worth individuals from around the world. The banking industry, renowned for its protection of its clients' privacy, is benefited by lax regulation. The Swiss regulator only requires that a hedge fund file a prospectus and the regulator regulates the marketing of the fund.¹⁹⁰ The minimal regulation required in Switzerland makes Swiss funds popular to high-net-worth European investors.¹⁹¹ Swiss funds are taxed, although foreign investors can have the tax rate of 35% rebated to avoid double taxation by their home country's tax authority.¹⁹² Switzerland is also a popular place for the sale of offshore funds because Swiss banks utilize these funds on behalf of their wealthy clients.¹⁹³ Hedge funds locate in Switzerland to be in close proximity to the large number of high-net-worth individuals who are customers of Swiss banks.

The French hedge fund industry is heavily regulated. Traditionally, only French banks had access to hedge funds.¹⁹⁴ Essentially, onshore hedge funds were banned in France because French regulators discouraged the use of leverage and speculative investments.¹⁹⁵ Offshore funds got around this regulation by structuring themselves so that they are allowable according to

¹⁸⁴ See *id.*

¹⁸⁵ BORLA & MASETTI, *supra* note 8, at 76.

¹⁸⁶ See O'Leary & McDermott, *supra* note 18, at 2.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.* at 3.

¹⁸⁹ See *id.* at 1-3; See also BORLA & MASETTI, *supra* note 8, at 76

¹⁹⁰ See BORLA & MASETTI, *supra* note 8, at 61.

¹⁹¹ *Id.*

¹⁹² *Id.* at 62-63.

¹⁹³ See *id.* at 61.

¹⁹⁴ See *id.* at 65.

¹⁹⁵ See LHABITANT, *supra* note 59, at 37.

regulation.¹⁹⁶ However, these structural changes change the fund so that in practicality it no longer resembles a hedge fund.¹⁹⁷ Offshore funds could not market their funds in France without prior approval of the French regulatory authority, the Commission des Operations du Bourse.¹⁹⁸ In practice, the Commission never gave its approval to the marketing of hedge funds, essentially banning offshore funds from France.¹⁹⁹

In 2004, there was a drastic change in France's approach to regulating hedge funds.²⁰⁰ The Commission des Operations du Bourse merged into the Autorité des marchés financiers ("AMF")²⁰¹ which has met with French investment managers to create rules to allow hedge funds to operate more freely in France.²⁰² Although the hedge fund industry in France will still be highly regulated, French authorities have opened up the rules to allow for the creation of a hedge fund industry in France.²⁰³

Traditionally, Germany banned the sale of hedge funds.. A traditional hedge fund cannot be domiciled in Germany because of laws requiring the fund to trade only listed securities, not engage in short selling, and not employ leverage.²⁰⁴ In the late 1990's, German banks introduced an innovative type of hedge fund in the form of an index-linked bond.²⁰⁵ These index-linked bonds are zero-coupon bonds that have their returns linked to an underlying hedge fund.²⁰⁶ The bonds guarantee the return of the investor's principal shown in the face value of the bond.²⁰⁷ Hedge funds not domiciled in Germany are heavily regulated in their marketing when they attempt to solicit German investors.²⁰⁸ Essentially, offshore hedge funds can only be sold in discreet private placements to sophisticated investors.²⁰⁹ Germany is an unattractive place to domicile a hedge fund because of excessive regulation—hedge fund managers are more likely to domicile their

¹⁹⁶ See BORLA & MASETTI, *supra* note 8, at 65.

¹⁹⁷ See *id.*

¹⁹⁸ LHABITANT, *supra* note 59, at 37.

¹⁹⁹ *Id.*

²⁰⁰ See Jerome Souter, *The Evolution of the Regulation of Alternative Management in France*, ALTERNATIVE INVESTMENTS MGMT. ASS'N J., Feb. 2005.

²⁰¹ *Id.* at 1.

²⁰² See *id.*

²⁰³ See *id.*; See also Sophia van Straelen, *France: A New Market Place for Hedge Funds?*, ALTERNATIVE INVESTMENTS MGMT. ASS'N J., Feb. 2005.

²⁰⁴ LHABITANT, *supra* note 59, at 34.

²⁰⁵ *Id.* at 35.

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ See BORLA & MASETTI, *supra* note 8, at 66.

²⁰⁹ See *id.* at 66-67.

hedge fund outside of Germany then sell shares of the fund within Germany to sophisticated German investors.

The Caribbean is also a popular place for hedge funds to domicile because of the tax and regulatory advantages of its laws. Most of the islands in the Caribbean do not tax hedge funds, nor do they heavily regulate hedge funds.²¹⁰ The most popular islands are the Cayman Islands and the British Virgin Islands. Another popular offshore financial center is Bermuda.

The Cayman Islands is a popular place to domicile hedge funds because the fund is tax-exempt and encounters little regulation. If the fund is larger than \$50,000 then it does not need to request a license; all it must do is provide a prospectus and a listing of any public offerings and pay a registration tax of \$875.²¹¹ There are over 3,600 hedge funds domiciled in the Caymans and they manage in excess of \$200 billion.²¹²

The British Virgin Islands also require little in the way of regulation or taxes. The fund must nominate a representative who is based full time in the British Virgin Islands.²¹³ An annual fee of \$350 is required as well.²¹⁴

Bermuda has more regulation although it does offer the same tax advantages as its Caribbean competitors. A hedge fund in Bermuda can structure itself in a variety of ways, but the most popular is the institutional scheme. The institutional scheme requires each investor to invest a minimum of \$100,000 and the assets of the fund must exceed \$50,000,000.²¹⁵ Funds that do not meet these standards are classified as a standard scheme and are subject to the normal regulation of the Bermuda Monetary Authority (BMA).²¹⁶ Bermuda is currently considering changes to their law similar to the new SEC rule that will require more paperwork for Bermuda-based hedge funds.²¹⁷ Finally, a hedge fund domiciled in Bermuda does not need to be managed in Bermuda, but certain administrative functions must be completed in Bermuda.²¹⁸

²¹⁰ See *id.* at 75-76.

²¹¹ *Id.* at 75.

²¹² Mitchell Pacelle & Glenn R. Simpson, *Offshore Banking Braces for Disruptions from Ivan*, WALL ST. J., Sept. 14, 2004, at B14.

²¹³ BORLA & MASETTI, *supra* note 8, at 75.

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ *Id.* at 75-6.

²¹⁷ Glenn R. Simpson & Gregory L. White, *Bermuda May Require Hedge Fund Licenses*, WALL ST. J., Nov. 18, 2004, at C1.

²¹⁸ BORLA & MASETTI, *supra* note 8, at 76.

E. Extraterritorial Effects of the New Rule

Soon after the SEC announced that it was considering a rule change that would require hedge funds to register with the SEC, the hedge fund industry reacted by alleging that if the new rule became effective, U.S. domiciled hedge funds would move offshore to avoid regulation.²¹⁹ The hedge fund industry also warned that talented hedge fund money managers would move offshore²²⁰ and that American investors would become limited in their investment choices.²²¹ If these events did occur, they would have a negative effect on American financial markets and would keep the SEC from accomplishing the purposes of the new rule.

In order to understand the extraterritorial effects of the rule change, an understanding of investor motives for investing offshore is required. Long before the regulation was contemplated, the offshore hedge fund market was thriving. Before this regulation was announced, 54% of all hedge funds were domiciled in the Caribbean, while only 33% of all funds were domiciled in the United States.²²² This number is somewhat misleading because although the majority of hedge funds are domiciled offshore, most Caribbean domiciled funds have no trading operations in the Caribbean.²²³ Most Caribbean hedge funds are actually partnerships formed by American hedge funds to provide investment opportunities for their tax-exempt investors.²²⁴ These funds are actively managed in the United States, although they are domiciled offshore.²²⁵ Since these hedge funds are domiciled offshore, U.S. regulators do not regulate them; rather, Caribbean regulators regulate them.

Investors desire offshore investments in the Caribbean for privacy and tax reasons.²²⁶ Offshore funds are popular among tax-exempt institutions and foreign investors who are exempt from United States income tax.²²⁷ An offshore fund is not designed to help investors avoid taxation, rather it is designed to assist investors whose assets are already exempt from taxation in their home countries.²²⁸ Tax-exempt institutions are required to pay taxes on any investment gains incurred through an investment partnership that uses debt to enhance its returns under Unrelated Business Taxable

²¹⁹ Sommer, *supra* note 15.

²²⁰ See Steinwurtzel et al., *supra* note 17.

²²¹ O'Leary & McDermott, *supra* note 18, at 3.

²²² See BORLA & MASETTI, *supra* note 8, at 8 fig.1.5.

²²³ Pacelle & Simpson, *supra* note 212.

²²⁴ See *id.*

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ JAEGER, *supra* note 27, at 188.

²²⁸ *Id.*

Income rules (UBTI).²²⁹ Onshore hedge funds are organized as limited partnerships and use debt to magnify their returns,²³⁰ thus bringing them under UBTI taxation. This means that tax-exempt institutions would have to pay taxes on the gains they earn from hedge fund investments. To keep their tax-exempt status, tax-exempt institutions invest offshore, where hedge funds are organized as corporations, not partnerships, meaning that the gains from hedge fund investments do not fall under the UBTI tax rules.²³¹

A headline in the May 18, 2003, New York Times read, "Bermuda Isn't Far, Hedge Funds Warn."²³² The headline was the result of public meetings between hedge fund managers and the SEC discussing the new rule to regulate hedge funds.²³³ Hedge fund managers warned that if the SEC enacted excessive regulation, then hedge funds would simply move offshore.²³⁴ These statements were more than just threats. Hedge funds are a collection of cash, investments, and human capital—all of which are very mobile. Hedge funds can change domiciles quickly and cheaply since they do not own any physical assets. The only asset that a hedge fund would have to transport would be its human capital. Another concern is that these rule changes would prompt offshore funds to exclude American investors to avoid registration under the new rule.²³⁵

A mass exodus of U.S. hedge funds would not bode well for the U.S. economy or for the effectiveness of the new rule to regulate hedge funds. If hedge funds relocated offshore, American investors would be at a comparative disadvantage to their international counterparts. As shown previously, hedge funds offer advantages to an investment portfolio. Hedge funds have a low correlation coefficient with equity markets while maintaining high returns and low risk levels. The low correlation coefficient makes these vehicles beneficial to investors. Further, if the best hedge fund managers move offshore, U.S. investors would be forced to invest in the remaining funds that would not be as well run as offshore funds. The exclusion of American investors from offshore funds would limit diversification possibilities and investment opportunities for American investors. Investors would be limited in their diversification options if they no longer had access to hedge funds.

²²⁹ Daniel Shapiro & Christopher Hilditch, *Getting the Structure Right*, HEDGEFUND INTELLIGENCE, http://www.hedgefundintelligence.com/ih/reports/2002_12/007.htm (indicating that gains are taxed only to the extent that they can be attributable to the use of debt).

²³⁰ STEFANO LAVINIO, *THE HEDGE FUND HANDBOOK* 157 (2000).

²³¹ Shapiro & Hilditch, *supra* note 229.

²³² Sommer, *supra* note 15.

²³³ *See id.*

²³⁴ *Id.*

²³⁵ O'Leary & McDermott, *supra* note 18.

More importantly, the SEC would not be able to accomplish the purposes of the new rule. As mentioned previously, the purposes of the new rule were to provide information to investors, to provide information to the SEC to assist it in monitoring U.S. financial markets, and to assist the SEC in preventing the risk of systemic loss in U.S. financial markets.²³⁶ If hedge funds moved offshore, beyond the jurisdictional reach of the SEC, the SEC would not be able to compile the information it sought by creating the rule. Further, U.S. investors would not receive the information they need to make informed investment decisions. If hedge funds do relocate offshore, it would defeat the purposes of the new rule and harm investors. If hedge funds do move offshore because of the passing of the new rule then it would have been better for the SEC not to implement the rule change in order to keep hedge funds onshore under a minimal level of oversight.

V. CRITICISM OF INDUSTRY THREATS

One of the biggest concerns about the SEC regulating hedge funds has been that in response, hedge funds would move offshore. The funds themselves have threatened that they would relocate offshore if the SEC regulated their industry.²³⁷ Despite their threats, onshore hedge funds will not relocate offshore. Investors have more power over hedge fund managers than they have had in the past, which allows investors to demand disclosure from hedge funds regardless of where the fund is located.²³⁸ The SEC also structured the new rule in a manner that it makes it practically impossible to move an onshore fund offshore to avoid regulation.²³⁹ The fact that many countries have followed the lead of the SEC and are now planning to regulate hedge funds also discourages international arbitrage.²⁴⁰ The combination of these market and regulatory roadblocks has created a landscape where there is little, if any, incentive for an American hedge fund to relocate offshore to avoid regulation.

²³⁶ *SEC Staff Report*, *supra* note 90; *see also* Eichengreen & Mathieson, *supra* note 155.

²³⁷ Sommer, *supra* note 15.

²³⁸ *See* Zuckerman & McDonald, *supra* note 140.

²³⁹ The SEC rule makes it difficult for hedge funds to move offshore by requiring all offshore hedge funds to register unless they have less than fifteen American investors. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,071-72 (Dec. 10, 2004) (to be codified at 17 CF.R. pts. 275, 279).

²⁴⁰ *See Hedge Fund Issue Too Big To Ignore*, FIN. TIMES, Oct. 25, 2004. *See also* Simpson & White, *supra* note 217.

A. Increase in Investor Power

Investments from institutional investors have risen since 2000.²⁴¹ Institutional investors now make up nearly half of the investment in hedge funds.²⁴² One in five pension funds and many charitable foundations and university endowments invest in hedge funds.²⁴³ These institutions invest, on average, ten percent of their massive portfolios in hedge funds.²⁴⁴ Institutional investors invest hundreds of millions of dollars in a specific fund compared to the millions that high-net-worth individuals have invested in the past.²⁴⁵ The large investments institutional investors make give them more power over hedge fund managers than high-net-worth individuals have. An institutional investor comprises a larger percentage of the hedge fund than one wealthy investor had previously; this consolidated power gives the institutional investor more power over the hedge fund manager.

With this increased power, institutional investors are demanding more information from hedge funds.²⁴⁶ Many institutional investors require their funds to provide quarterly unaudited reports and annual audited financial statements.²⁴⁷ Institutional investors are also demanding daily and weekly changes in net asset values, elaborate measurements of the firm's risk, and details about the hedge fund's back-office operations.²⁴⁸ Some institutional investors have gone as far as asking for the hedge fund's actual positions and industry and sector exposure.²⁴⁹ These demands are not limited to institutional investors. Many wealthy individual investors are now requiring more information about the performance and risk of the hedge funds.²⁵⁰ The disclosures hedge funds are making to their investors far exceed the mandatory disclosures the SEC is requiring in its new rule to regulate hedge funds.²⁵¹ Market forces are demanding more information than regulators are asking for.

²⁴¹ See Zuckerman & McDonald, *supra* note 140. See also L HABITANT, *supra* note 35, at 11.

²⁴² L HABITANT, *supra* note 35, at 11 (indicating that both institutional investors and financial institutions are included as institutional investors).

²⁴³ Frank Partnoy, *Road Rules for Hedge Funds*, N.Y. TIMES, Dec. 15, 2004, at A33.

²⁴⁴ *Id.*

²⁴⁵ Zuckerman & McDonald, *supra* note 140.

²⁴⁶ *Id.*

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ Robert Frank, *More Fret over Hedge Funds*, WALL ST. J., Feb. 1, 2005, at C1.

²⁵¹ Compare Zuckerman & McDonald, *supra* note 140 (reporting that many hedge funds respond to customer concerns by providing weekly, and sometimes daily, values of net assets), with Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed.

These market forces do not always force hedge fund managers to disclose more information. For instance, when Goldman Sachs' star trader, Eric Mindich, formed his own hedge fund in the spring of 2004, he provided investors essentially with no information about his hedge fund, yet investors still fought to join his hedge fund.²⁵² In fact, Mr. Mindich had to turn away investors because he had already received such a large amount of money in his fund.²⁵³ It is questionable whether this exuberance in Mr. Mindich's hedge fund is rational. Although Mr. Mindich is likely a very capable fund manager, investors cannot make an informed investment decision without having any substantive information about the hedge fund. It appears investors are speculating and exhibiting the type of behavior consistent with a "bubble" being present in the market.²⁵⁴ Although market forces do not always demand increased disclosure from every hedge fund, almost all hedge funds are disclosing more information to investors.

B. Decrease in the Power of Hedge Fund Managers

As investor power has increased, the power of hedge fund managers has decreased because of increased competition. Hedge funds are able to generate large returns by taking advantage of market inefficiencies.²⁵⁵ As more funds enter the marketplace, the market becomes more efficient making it difficult for hedge funds to generate the large returns that made them famous. Record amounts of money have flowed into the hedge fund industry recently²⁵⁶, bringing with it thousands of new funds.²⁵⁷ In the fourth quarter of 2004 alone, investors invested \$27 billion in hedge funds.²⁵⁸ With this new investment has come a proliferation of new funds that often crowd out incumbents, making it difficult to generate large returns.²⁵⁹ So much money has flowed into merger-stocks, stocks for short selling, and converti-

Reg. 72,054, 72,077 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279) (describing SEC requirement for quarterly audits).

²⁵² Gregory Zuckerman & Henry Sender, *Ex-Trader Creates Hot Hedge Fund, And a Traffic Jam*, WALL ST. J., Jan. 12, 2005, at A1.

²⁵³ *Id.*

²⁵⁴ For an excellent description of bubble behavior, see generally BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 34-51 (8th ed. 2003) (describing incidents of bubble behavior including the Dutch tulip bulb craze of the seventeenth century, the British South Sea Bubble of the eighteenth century, and the Wall Street bubble of the 1920's).

²⁵⁵ See Greupner, *supra* note 9, at 1560.

²⁵⁶ See Wright, *supra* note 77.

²⁵⁷ See Zuckerman & McDonald, *supra* note 140 (describing \$600 billion increase in the size of the hedge fund market over four years and the diverse market of over 8000 hedge funds pursuing a variety of investment objectives).

²⁵⁸ Wright, *supra* note 77.

²⁵⁹ Zuckerman & Sender, *supra* note 252.

ble bonds that there are not many opportunities for high returns in these categories any more.²⁶⁰ As returns diminish in the hedge fund industry, investors will demand concessions from fund managers or they will move their money elsewhere.²⁶¹ To placate investors, managers will inevitably disclose more information about their funds.²⁶² Some hedge fund managers will likely begin to deviate from their stated investment strategies and pursue new strategies in search of larger returns.²⁶³ Already, desperate hedge fund managers are turning to riskier strategies, such as long only funds, to generate the large returns that they are famous for generating.²⁶⁴

In the current competitive state of the hedge fund industry, hedge fund managers will not be able to relocate their funds offshore unless their investors want them to do so. Although, managers want to relocate offshore to avoid upcoming SEC disclosures, investors are demanding that hedge fund managers make disclosures in excess of what the SEC is requiring, thus defeating the managers' purpose in moving offshore.

C. Regulatory Roadblocks to Arbitrage

In addition to the market conditions that prevent hedge funds from moving offshore, there are regulatory roadblocks that prevent hedge funds from moving offshore to avoid this regulation. One of the main roadblocks is the SEC's new rule change. The new rule serves as a roadblock because a hedge fund manager can avoid regulation only if he or she has less than fifteen American clients.²⁶⁵ The majority of onshore funds are comprised predominately of American investors. If the fund manager wants to move the fund offshore, the manager must find a new group of foreign investors with enough money to invest to replace the hedge fund's American investors. This is difficult to do in practice because of increased competition in the hedge fund industry. This provision of the rule change makes it difficult for hedge funds to employ regulatory arbitrage.

Another regulatory roadblock to fund managers is the adoption of the new SEC rule by other foreign regulatory agencies. Many European countries already regulate hedge funds more strictly than the United States.²⁶⁶ Other European countries, like the United Kingdom, are currently evaluating the American rule and considering changes to their own oversight of

²⁶⁰ Zuckerman, *supra* note 44.

²⁶¹ See Frank, *supra* note 250.

²⁶² Zuckerman & McDonald, *supra* note 140.

²⁶³ See Frank, *supra* note 250.

²⁶⁴ Zuckerman, *supra* note 44.

²⁶⁵ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,071-72 (Dec. 10, 2004) (to be codified at 17 CF.R. pts. 275, 279).

²⁶⁶ See BORLA & MASETTI, *supra* note 8, at 60-78.

hedge funds.²⁶⁷ Some offshore financial centers have taken notice of the new regulation. For instance, Bermuda is considering making a change in its law to regulate hedge funds.²⁶⁸ The increased scrutiny from regulators across the globe only compounds the difficulty hedge fund managers would have trying to relocate their hedge funds offshore.

D. Evidence

To date, there has been no evidence that hedge fund managers are moving their onshore funds offshore in response to this regulation. In fact, early evidence shows that hedge funds are staying in the United States and disclosing more information about their trading strategies and positions to investors.²⁶⁹ Time will tell whether hedge funds carry out on their promises to move offshore. The evidence today appears to show that investors are investing offshore not to avoid regulation, but rather to take advantage of the tax incentives offshore.

An evaluation of market forces and the regulatory environment shows that hedge funds will not move offshore in response to the new rule because the market and regulatory climate will not allow it. In fact, market forces have solved the information asymmetry problem themselves. Market forces have forced hedge fund managers to disclose more information about their hedge funds to investors, helping investors to get the necessary information they need to make rational, informed investment decisions. The SEC's new rule does not assist in solving the information asymmetry problem with investors because market forces are forcing hedge funds to disclose information to investors without the SEC's new rule. The main problem that the SEC's new rule solves is the problem the SEC had in obtaining information from hedge funds. The disclosure requirements of the new rule will allow the SEC staff to determine the systematic risk that hedge funds pose on our financial markets. The new rule will also ensure the efficacy of the information that hedge funds disclose to their investors.

VI. CONCLUSION

Hedge funds are currently the darlings of the investment community because of their reclusive nature and tantalizing returns. Hedge funds congregate to Greenwich, Connecticut and other glamorous suburbs outside of

²⁶⁷ Press Release, FSA Launches Debate on the Impact of Hedge Funds in the UK (June 23, 2005), available at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2005/068.shtml>.

²⁶⁸ Simpson & White, *supra* note 217.

²⁶⁹ Zuckerman & McDonald, *supra* note 140.

New York, San Diego, Boston, and San Francisco.²⁷⁰ The best and the brightest of Wall Street are packing up their bags and leaving Manhattan to start their own hedge funds.²⁷¹ And who can blame them? Sixteen hedge fund managers in 2003 made more than \$100 million, with George Soros leading the way making \$750 million in 2003.²⁷² Hedge funds were flying under the radar of regulators, allowing hedge fund managers to operate their funds without any interference from bureaucrats in Washington, D.C. On July 10, 2004, the SEC announced that it was proposing a rule that would bring hedge funds under the watchful eye of SEC regulators in Washington, D.C.

Not surprisingly, hedge fund managers resisted the rule and hired an army of lawyers and lobbyists to quash the proposal. The SEC was flooded with comment letters from law firms and industry groups that opposed the new rule.²⁷³ Lobbyists spoke to members of Congress who joined in the fight against the new rule. Hedge fund managers threatened to pack their bags and leave the U.S. for tropical destinations in the Caribbean. Then in December of 2004, the SEC approved the rule and nothing happened. Hedge fund managers had their teams of lawyers draw up compliance plans as hedge fund managers went back to work in their comfortable offices in Greenwich.

The reason why hedge fund managers will not move offshore is because it is not feasible. Market conditions, foreign regulators, and provisions of the new rule make it impractical for hedge funds to move offshore. In response to the SEC's rule change, regulators across the world have made changes to their securities laws to bring hedge funds under their regulatory jurisdictions. Thus, moving offshore will not always exempt hedge funds from regulation.

The SEC designed its new rule to make it difficult for hedge funds to move offshore. Hedge funds can only be exempt from the new rule if they are comprised of less than fifteen American investors. Most onshore hedge funds have hundreds, if not thousands, of American investors, making it practically impossible for hedge funds to move offshore. Finally, and most importantly, hedge funds would receive no benefit from moving offshore because of market pressures. Increased competition within the hedge fund industry has reduced the power of hedge fund managers while increasing the power of investors. Hedge fund managers can no longer withhold

²⁷⁰ *The New Money Men*, ECONOMIST, Feb. 17, 2005, available at http://www.economist.com/finance/displaystory.cfm?story_id=3666459.

²⁷¹ Zuckerman & Sender, *supra* note 252.

²⁷² *The New Money Men*, *supra* note 271.

²⁷³ See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,058 (Dec. 10, 2004) (to be codified at 17 CF.R. pts. 275, 279).

pertinent information about their funds from investors. In fact, many investors are demanding more information than the SEC is requiring. If hedge fund managers are forced by their investors to divulge information about the fund, there is little incentive for hedge fund managers to avoid regulation by moving off shore.

The information that hedge funds provide about themselves will insure the free flow of accurate information to hedge fund investors and regulators alike. Although the new rule will not cause an influx in offshore hedge funds, it will have other extraterritorial effects. It is likely that individual American investors will be excluded from small to mid-size offshore funds that do not want to comply with American securities law. Further research could evaluate how these limited investment opportunities affect American investors. Other areas of inquiry are needed to evaluate how foreign regulators react to the SEC's new rule and to what extent they follow the lead of U.S. regulators.

Hedge funds have a beneficial impact on U.S. financial markets by making the markets more efficient. Hedge funds help to ensure that prices in the U.S. financial markets are accurate. However, for all the good hedge funds do, their fraudulent use can severely weaken U.S. financial markets. When the SEC was contemplating a new rule to regulate hedge funds, it had to be careful to not only discourage the destructive potential of hedge funds but also to promote the positive behavior of hedge funds. The SEC walked this line masterfully in creating the latest rule to regulate hedge funds. The new rule promotes the free sharing of information that makes markets more efficient, while at the same time discouraging fraudulent or inaccurate reporting of information. The new rule is not overbearing either. Despite hedge fund managers' threats, the new rule will not force hedge funds offshore; rather, the new rule has facilitated greater oversight of hedge funds abroad thereby securing world financial markets. The SEC's new rule helps investors and regulators receive the information they need to make informed, rational decisions. Informed investors and regulators will in turn make our financial markets stronger.

